

Real Estate Alert

## Implications of the New California LLC Act

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On January 1, 2014, a new law governing limited liability companies ("LLCs") went into effect in California. The California Revised Uniform Limited Liability Company Act ("RULLCA")<sup>1</sup> superseded in its entirety the prior limited liability company act in California, the Beverly-Killea Limited Liability Company Act (the "Prior Act"), and enacted numerous substantive changes to the Prior Act's governance of LLCs. Although the Prior Act continues to govern agreements, including operating agreements, entered into by LLCs and their members and managers prior to January 1, 2014 (together with votes or consents by members or managers prior to such date), RULLCA provides that any acts taken by an LLC or its members or managers on or after January 1, 2014 will be governed by RULLCA rather than the Prior Act. Although not explicit in RULLCA, the new law implies that the votes or consents by members or managers after January 1, 2014 are governed by RULLCA, not the Prior Act. Consequently, RULLCA does impact pre-2014 operating agreements and may significantly modify the rights and obligations of members and managers on and after January 1, 2014. Of particular concern in RULLCA are certain rules which apply by default to LLCs absent express provisions in the LLC operating agreement. For example, one such default rule requires unanimous member approval for amendments to operating agreements; the Prior Act's default rule required only the majority of the interests of the LLC. Given this default rule, operating agreements should be clear on the voting threshold for amendments to the operating agreement or an LLC risks having members with small interests retaining veto power over the will of the majority.

Many, but not all, of RULLCA's default rules may be overridden by the operating agreement, if the operating agreement is drafted correctly.

Some of the key substantive revisions to California LLC law imposed by RULLCA and the practical implications of those revisions are summarized below.

### LLC Management and Authority of Managers

Under RULLCA, an LLC will be member-managed by default. To create a manager-managed LLC, both the articles of organization and the operating agreement must explicitly state such structure.<sup>2</sup> Since the Prior Act permitted the establishment of a manager-managed LLC by a statement to that effect solely in the articles of organization, managers should review these organizational documents to confirm that the designation is clear in both documents.

The Prior Act included only a few default rules concerning when a manager of a manager-managed LLC would need to obtain the consent of members prior to taking action; however, RULLCA expands the consent rights of members in such situations. Specifically, RULLCA includes a requirement that the consent of all members in a manager-managed LLC is required to (i) sell, lease, exchange, or otherwise dispose of all, or substantially all, of the LLC's property, with or without the goodwill, outside of the ordinary course of the LLC's activities; (ii) approve a merger or conversion; (iii) undertake any activity outside of the ordinary course of the LLC's activities; or (iv) amend the operating agreement. The foregoing requirements may be overridden in a written operating agreement.

If an operating agreement created under the Prior Act provides that approval by members (whether all of the members or a majority of the members) is required only for those actions specifically set forth in the operating agreement, the manager would likely retain the same powers despite RULLCA's default rules.



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Nonetheless, managers of a California LLC, particularly an LLC with multiple members, should review and amend operating agreements as needed to enumerate those actions which require the consent of all or a majority of the members and those that do not, especially those actions which would otherwise be subject to RULLCA's default rules. Further, consideration should be given as to whether the operating agreement sufficiently defines the matters that are within the "ordinary course of the LLC's activities," a nebulous term that could serve as a potential source of conflict between managers and members. In short, the delegation of powers to a manager (and the limitations to such powers) should be specified in the operating agreement.

## **Fiduciary Duties**

Unlike the Prior Act, RULLCA is specific about the fiduciary duties owed by members (in a member-managed LLC) and managers (in a manager-managed LLC) and the limitations on modifications to such duties, which include the duty of loyalty, the duty of care, and the duty of good faith and fair dealing.<sup>3</sup> Specifically, (i) the duty of loyalty cannot be eliminated, but an operating agreement may identify activities that do not violate the duty of loyalty, provided the activities are not manifestly unreasonable; (ii) the duty of care cannot be eliminated or unreasonably reduced; and (iii) the duty of good faith and fair dealing may be modified as long as the new standards are not manifestly unreasonable.

RULLCA provides that the fiduciary duties of a manager may be modified only by a written operating agreement with full disclosure and the "informed consent" of the members.<sup>4</sup> RULLCA clarifies that informed consent of a member differs from a member who is deemed to consent to the operating agreement when such party becomes a member of an LLC. Thus, an LLC that elects to modify the default fiduciary duties imposed by RULLCA should determine the appropriate actions necessary to be able to demonstrate that informed consent of the members was obtained. Additionally, if modification of the fiduciary duties is intended, the modifications should be targeted and the operating agreement should specifically authorize certain actions that might otherwise be viewed as conflicting with the duty of loyalty (e.g., engaging in a competing business venture) or the duty of care (e.g., permitting the delegation of certain manager duties to officers or agents).

## **Indemnification**

The Prior Act provided that an operating agreement may provide for the indemnification of any person acting on behalf of the LLC. Conversely, RULLCA's default rule is that the LLC must indemnify members of member-managed LLCs and managers of manager-managed LLCs, provided that members and managers, as the case may be, comply with their statutory duties.<sup>5</sup> As a result, if a pre-2014 operating agreement does not sufficiently address the indemnification of members and managers, RULLCA could alter the expectations of members and managers within the operating agreement.

RULLCA's default rule may be overridden in a written operating agreement, except with respect to (i) breaches of the duty of loyalty, (ii) receipt by such party of a financial benefit to which such party was not entitled, (iii) liability for excess distributions, (iv) intentional inflictions of harm on a person or the LLC, and (v) intentional violations of criminal law.<sup>6</sup>

## **Disassociation**

Under RULLCA, certain events now automatically result in a member's disassociation: (i) the death of a member who is an individual; (ii) in a member-managed LLC, the appointment of a guardian or conservator for an individual who is a member; (iii) in a member-managed LLC, a judicial order that a member who is an individual is incapable of performing the member's duties; and (iv) in a member-managed LLC, the member becomes a debtor in bankruptcy.<sup>7</sup>

Upon disassociation, the member's status is converted to that of a transferee who retains economic rights, but loses all rights to participate in the management of the LLC or retain information concerning the LLC other than a right to an accounting from the date of disassociation. Further, a disassociated member who is also serving as a manager is automatically removed as manager.<sup>8</sup> Lastly, unlike the Prior Act, RULLCA is

silent about whether a member who disassociates is entitled to payment for the member's interest in the LLC. Thus, unless the operating agreement addresses this situation, a disassociating member may have an argument for entitlement to payment for his or her interest in the LLC. The foregoing default rules should be addressed and modified in operating agreements (or amendments to same) as desired by the members.

## Foreign LLCs

Although RULLCA provides that the statute applies to both domestic and foreign LLCs as of January 1, 2014,<sup>9</sup> it also provides that the law of the state in which an LLC is formed governs, among other matters, the "internal affairs" of the LLC and the "management authority" of the members and managers of the LLC.<sup>10</sup> One reading to synchronize those potentially contradictory provisions is to interpret California law as applying to all aspects of an LLC not otherwise specifically carved out in Section 17708.01(a) of the Code.<sup>11</sup> Even if that reading proves accurate, it is still unclear which aspects of the LLC would be governed by California law. For example, which components of an LLC's operation constitute "internal affairs"? As currently constituted, RULLCA is opaque concerning its application to foreign LLCs. This ambiguity is troubling in many ways. Where parties prefer the use of Delaware law to govern their LLCs, manager authority and limitations on fiduciary duties, among other matters, could be impacted by the confusion of which state law is applicable. The language in RULLCA has some similarities to Section 2115 of the Code, which deals with foreign corporations, but Section 2115 is clearer about which state law is applicable and requires a certain number of contacts to permit California law to extend to foreign corporations. Interpretation of the internal affairs doctrine, another choice of law rule applicable to corporations, may also lend some guidance. Ultimately, further clarity will be needed to determine if a set of provisions similar to Section 2115 and/or the internal affairs doctrine applies to RULLCA. To address this issue, one approach may be to include in the operating agreement of a foreign LLC a list of all of the matters deemed to be the "internal affairs" of the LLC; however, one concern with that approach is that if a particular matter is not listed, it could be interpreted as falling outside the scope of "internal affairs." Another approach may be to state that the operating agreement governs the internal affairs of the LLC and the authority of its members and managers, as the case may be, and to provide that all of the matters set forth in the operating agreement are to be considered the "internal affairs" of the LLC. With either approach, the operating agreement should provide that the members waive the application of any other jurisdiction other than the foreign jurisdiction of the LLC to the fullest extent permitted by law.

## Reimbursement

RULLCA requires reimbursement of members and managers for expenses incurred on behalf of the LLC unless such expenses violate any fiduciary duties.<sup>12</sup> The Prior Act merely permitted such reimbursement. This default rule should be overridden as required under the operating agreement if LLCs would prefer that such reimbursement not be mandatory or prefer that reimbursement otherwise be subject to certain conditions.

## Conclusion

RULLCA makes substantive changes to the law governing LLCs in California. If the operating agreement of an LLC does not sufficiently address the modifications and more expansive default rules codified by RULLCA, the rights and obligations of members and managers could be altered by RULLCA in a manner that conflicts with or overrides the intentions of the operating agreement.

In light of these changes, operating agreements of California LLCs in effect prior to January 1, 2014 should be reviewed, and perhaps amended, to address the impact RULLCA may create on existing contractual arrangements. Additionally, existing California LLCs may weigh the possibility of converting the entity to another domicile, such as Delaware; however, as discussed above, changing the domicile of a California LLC to another state will not completely take the LLC beyond the reach of RULLCA.

Further, prior to creating a new LLC, an examination of RULLCA should be undertaken to determine the best

approach to address RULLCA's default rules in the operating agreement, or, alternatively, to determine if organization of the LLC in another state is a more prudent approach.

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## Endnotes

<sup>1</sup> Codified at Section 17701.01 et. seq. of the California Corporations Code (the "Code").

<sup>2</sup> See Section 17704.07 of the Code.

<sup>3</sup> See Section 17704.09 of the Code.

<sup>4</sup> See Section 17701.10(e) of the Code.

<sup>5</sup> See Section 17704.08 of the Code.

<sup>6</sup> See Section 17701.10(g) of the Code.

<sup>7</sup> See Section 17706.02 of the Code.

<sup>8</sup> See Section 17706.03 of the Code.

<sup>9</sup> See Section 17713.04 of the Code.

<sup>10</sup> See Section 17708.01 of the Code.

<sup>11</sup> Section 17708.01(a) of the Code reads as follows: "The law of the state or other jurisdiction under which a foreign limited liability company is formed governs all of the following: (1) The organization of the limited liability company, its internal affairs, and the authority of its members and managers. (2) The liability of a member as member and a manager as manager for the debts, obligations, or other liabilities of the limited liability company."

<sup>12</sup> See Section 17704.08 of the Code.

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